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SUBJECT: SERBIA OFFERS INCENTIVES TO FOREIGN INVESTORS

REF: Belgrade 531

SUMMARY

¶1. (U) Attracting foreign direct investment is increasingly becoming a priority for the Serbian government. The GOS is developing a range of incentives for investors, including cash grants to investments resulting in significant job creation, as well as tax incentives in the form of credits and reduced corporate tax rates. Finance Minister Dinkic announced on October 21 that a British apparel manufacturer would be the first grant recipient, snaring a EUR 6 million subsidy for a plant in Vranje that will employ 3,000. A proposed Law on Foreign Investments is in parliamentary procedure, but its future is uncertain due to implementation concerns and opposition from the World Bank and the Serbian Investment and Export Promotion Agency (SIEPA). The GOS incentives are particularly aimed at stimulating greenfield investments. END SUMMARY.

¶2. (SBU) Greenfield investments in Serbia have been rare. U.S. can manufacturer Ball Packaging was the first major project, and Slovenia's Gorenje on October 16 opened a EUR 20 million factory in Valjevo that will employ 330 (later, up to 1,000) in the manufacture of refrigerators and freezers. Minister of International Economic Relations (MIER) Milan Parivodic announced at the factory that FDI will reach USD 3.5 billion by the end of the year. Serbian economic policy-makers are finally focusing on the need for greenfield investment if the country is to achieve a significant reduction in unemployment, which now is near 21 percent. Several donors, including USAID and the EU (through a project directed by the World Bank's Multilateral Investment Guarantee Program), are working with Serbian agencies as they seek to modify the legal and physical infrastructure for investment.

FINANCIAL INCENTIVES FOR JOB CREATION

¶3. (U) In order to provide further financial incentives for greenfield investments in specific industries, the GOS adopted a decree in late June 2006 to permit cash grants to investment projects in all areas, except for trade, tourism, hospitality and agriculture. Eligible companies are those establishing new ventures in manufacturing, services activities that can be marketed internationally, and the research and development (R&D) sector. For each of these areas, the incentives and conditions are as follows:

Investments in manufacturing:
-- Available funds: starting at EUR 2,000 up to EUR 5,000 per every new employee,
-- Minimum investment: between EUR 1 million and EUR 5 million, depending on the unemployment rate in the

municipality where the investment is made,
-- Minimum number of new positions: 50.

Investments in international services:
-- Available funds: starting at EUR 2,000, up to EUR 10,000 per every new employee,
-- Minimum investment: EUR 1 million
-- Minimum number of new positions: 10.

Investments in the R&D sector:
-- Available funds: starting at EUR 5,000 up to EUR 10,000 per every new employee,
-- Minimum investment: EUR 1 million,
-- Minimum number of new positions: 10.

¶4. (U) Investment projects will be reviewed and scored by Serbia's Investment and Export Promotion Agency (SIEPA), based on predetermined criteria. Upon a successful evaluation by a five-member commission represented by the Deputy Prime Minister's office, Ministry of Economy, Ministry of International Economic Relations (MIER), Ministry of Finance, and SIEPA, the funds will be paid out in four increments over the project?s life:

1st increment: after concluding the contract for sale or lease of land,
2nd increment: after obtaining construction approval,
3rd increment: after obtaining the right-to-use permit,
4th increment: after achieving full employment envisaged by the investment project.

¶5. (U) For example, UK-based Alena Ltd. recently announced plans to build an apparel factory in Vranje. This greenfield investment is expected to generate 3,000 new jobs and produce 100,000 garments weekly. Alena submitted an application to receive a cash grant for the investment project, and on October 20, the GOS awarded the first installment of EUR 6 million. Alena purchased one division of existing apparel manufacturer Yumco, and it also will lease space from Yumco during the construction phase.

¶6. (U) The commission scores and evaluates projects based on the following criteria: 1) investor?s references, 2) participation of domestic suppliers in the final product and investment effect on local companies, 3) investment?s sustainability and viability, 4) effect related to R&D, 5) effect on human resources, 6) environmental impact, 7) international turnover of services for investments in this area, 8) effect on development of the local community, and 9) municipality support related to deduction of local fees. The final cash grant will be based on the final score of the project.

¶7. (U) In a press conference of the contract signing with Alena Ltd, Minister of Finance Mladjan Dinkic announced that the GOS is ready to offer EUR 20 million to 100 million from the National Investment Plan to a foreign company willing to open a new automobile factory in Kragujevac, home of the failing Zastava Automobile factory. He said that just this week Serbia is the process of concluding five greenfield investments that will employ some 5,000 people in Vranje, Uzice, Valjevo, Indjija and Kragujevac.

¶8. (U) In addition, the GOS has obligated EUR 45 million for municipalities to develop industrial parks where various companies could be concentrated in one location sharing the same infrastructure. According to SIEPA, some 49 municipalities have submitted industrial park proposals for funding consideration.

TAX INCENTIVES

¶9. (U) Serbia?s tax law has recently been amended to offer several tax incentives to new investors. Corporate profit tax is levied under current law at the uniform rate of 10 percent, with non-residents taxed only on income earned in Serbia. Companies under the current law are exempt from corporate profit tax for up to 10 years, starting from the

first year in which they realize profit, if: 1) they invest in fixed assets an amount exceeding 600 million dinars (approximately EUR 7.5 million) and 2) during the investment period employ at least 100 additional employees for an indefinite period.

¶10. (U) Companies that do not meet the requirements for the 10-year exemption still may utilize an investment tax credit that permits a reduction in tax due equal to 20 percent of the amount invested in fixed assets for the respective tax period. This reduction may exceed 50 percent of the total tax liability. If not used entirely in the course of one year, this tax credit can be carried forward for a maximum of 10 years.

¶11. (U) A number of sectors (agriculture, production of textile yarn and fabrics, garment manufacture, leather processing, production of base metals and standard metal products, production of any sort of machinery, electronic goods, medical instruments, or motor vehicles, recycling, and video production) may obtain a tax credit in the amount of 80 percent of investments made in fixed assets, with the unused portion to be carried forward for up to 10 years. Small enterprises outside of these sectors may receive tax credits equal to 40 percent of the amount invested in fixed assets in the current year (credit not to exceed 70 percent).

¶12. (U) In addition, the tax law offers incentives for employing new workers. A taxpayer who employs new workers is entitled to a tax reduction equal to 100 percent of the gross salaries. This tax credit is recognized for two years from the day of employment of new workers, provided that the number of employees is not reduced during that period.

¶13. (U) A taxpayer generating profit from a newly-established operating unit in an underdeveloped region (as designated by the GOS) will receive a tax credit for two years in an amount proportionate to the profit of that unit in the overall profit of the company.

¶14. (U) The tax law also provides for accelerated depreciation of fixed assets, tax exemptions for concession-related investments, social insurance contribution exemptions, income tax credits, and customs duty exemptions for certain goods and equipment imports. Drawback provisions of various kinds are also stipulated in the customs law, providing for a suspension of customs duties on certain imports inputs which will be processed and re-exported.

¶15. (U) Recent modifications to the Law on Income Tax in July 2006 provide additional, age-based tax incentives to employers. For hiring new employees younger than 30 years of age or older than 50, employers are exempt from social contributions for three years. For new employees ages 45 to 50, employers pay only 20 percent of the required contributions for three years. Currently, employers pay 73 cents on the dollar in social contributions, but after January 1, 2007, the rate will be reduced to 61 cents on the dollar.

UNCERTAIN FUTURE FOR PROPOSED LAW ON FOREIGN INVESTMENT
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¶16. (U) On July 27, the GOS adopted the draft Law on Foreign Investments for submission to Parliament. Minister Milan Parivodic of MIER personally drafted the proposed legislation, which would regulate foreign investments in Serbia and guarantee freedom of investment and investment rights to foreign investors. The law also envisages the establishment of a special procedure for the purpose of "prompt and efficient implementation of foreign investment," the so-called "one-stop shop."

¶17. (U) The draft law requires the creation of one-stop shops at the municipality level to facilitate and service the terms of investment agreements signed between the investor and the municipality. These agreements would spell out the obligations of both parties during the investment process.

¶18. (U) The draft law also stipulates criteria for categorizing certain investments as ?of general interest.? For these larger investments, MIER would be the responsible entity for the one-stop shop. Article 46 of the law also provides for offering special incentives to these investors, such as lower real estate and rental prices, construction of infrastructure by the republic, grants for new jobs created, etc.

¶19. (U) Although there is consensus that FDI is important to Serbia?s future economic development, many have expressed doubts that this law will produce the efficient investment facilitation it seeks to achieve. Jasna Matic, director of the Serbian Investment and Export Promotion Agency (SIEPA), told econoffs that this law is too complex and may actually be counterproductive to foreign investment promotion.

¶20. (U) Matic said that most municipalities and MIER lack the capacities to implement the one-stop shop. She also complained that SIEPA was not consulted during the drafting of the law. In fact, SIEPA is not mentioned once in the law, and it is unclear what role SIEPA would play in investment facilitation. For continuity purposes, Matic advocates for one entity to support the investor from start to finish of a project.

¶21. (SBU) Matic stated that the government?s role, MIER specifically, should be to create a level playing field for investors. By subjecting investors to another layer of bureaucracy with project committees and investment agreements that explicitly state what both parties will do, she fears that this will send the wrong message to investors and that they will look elsewhere for ?easier? investments. Matic told econoffs that she would ask the Speaker of Parliament to pull it from Parliament?s agenda. (Note: Speaker Predrag Markovic, until recently, was a member of the G17 party, as is Matic. Parivodic's position, on the other hand, is an appointment controlled by Prime Minister Kostunica's Democratic Party of Serbia; partisan politics may play a role in the strained relations between G17 and the Ministry.)

¶22. (U) Carolyn Jungr, Director of the WB in Serbia, sent a letter to the GOS on August 17 expressing concerns over the the law on foreign investments. The fact that the Ministry's law does not mention the government's investment promotion agency, SIEPA, sends an unfortunate signal to the investment community. She said that the proposed law introduces a significant degree of uncertainty about the treatment of investors through discretionary authority for providing services and granting incentives, while potentially increasing the bureaucratic requirements under which investors may obtain such services. She also voiced concerns over "codifying the unproven one-stop shop in a law," and stated that many of the concepts prescribed in the draft law are not in line with international best practice and could have a negative impact on investor perceptions of Serbia.

¶23. (U) Jungr told econ chief that her primary concern at this point was not the foreign investment law, but a companion law on industrial parks. In a letter to the GOS on August 25, she criticized a provision that appears to require private ownership of such parks, stating that this model would create complications, bureaucratic procedures and significant uncertainty for investors. She raised several questions based on the current draft: Who would own the infrastructure at the parks? If the infrastructure is privately owned, why would the Government provide a large share of the financing? If the land is to be owned separately from the industrial park, how will the relationship between the land owner and the park owner be regulated? Jungr also said that it would be more prudent for the GOS to develop a strategy first, then draft the law based on the strategy. (Parivodic later told the Ambassador that it was not the intent of the law to prohibit the establishment of non-private industrial parks.)

POLITICAL CLIMATE COULD DELAY LARGE PRIVATIZATIONS
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¶24. (SBU) Considering that Parliament will meet only once between the referendum on the new constitution and the expected parliamentary elections, some 40 laws in procedure (including the draft Law on Foreign Investments) almost certainly will be adopted only after election of a new government. In addition, Finance Minister Dinkic said on October 16 that the new government will finish the process of privatization, stating that the sale of Serbian Oil Company (NIS) would be delayed. (However, sources at the Ministry of Economy told econ chief that the NIS tender would be delayed because of a technical error in the tender documentation, regarding the number of shares to be purchased by workers, and Dinkic's intervention was gamesmanship. Other sources at the Agency for Privatization told us that the tender for copper mine RTB Bor would be delayed only because many would-be bidders needed more time.)

COMMENT

¶23. (SBU) The important story is not the debate over which mechanism to use in supporting foreign investors in Serbia. Rather, it is the increased GOS realization that FDI is essential to future economic development. The GOS is taking steps towards removing administrative barriers while using FDI incentives to encourage job creation. Recognizing a gap at the local level in facilitating foreign investment, the Embassy plans to work with economically active and important municipalities through USAID's Municipal Economic Growth Activity (MEGA) program to build the capacity of cities to attract and retain investments. We expect to announce very soon an expansion in this aspect of the MEGA program from 10 to 24 municipalities.

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